ORIGINAL

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	
Price Cap Performance Review for Local Exchange Carriers	CC Docket 94-1
Notice of Proposed Rulemaking	

COMMENTS OF BELL ATLANTIC

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SUMMARY

The existing price cap plan for local exchange carriers ("LECs") was a step in the right direction, and has been an improvement over traditional rate of return regulation for consumers and LECs alike. Nonetheless, improvements are needed to duplicate more fully the incentives and benefits of a competitive market, and to provide LECs the flexibility they need to compete in a rapidly changing environment. These changes will promote economically efficient investment in the nation's infrastructure, deliver consumers the benefits of true competition, and establish regulatory parity between direct competitors.

Since the current price cap plan was adopted, the telecommunications landscape has undergone dramatic changes. Previously distinct industries are converging, and competition is intensifying. Nowhere are these trends more apparent than in the interstate access business, where technological change has driven competitive entry from a host of new providers -- entry that the Commission itself has strongly promoted. The change has been so profound that more than two-thirds of the demand for high capacity access in Bell Atlantic's region comes from areas that are already served by competing providers. Other services are or soon will be equally competitive.

This environment demands a flexible regulatory structure that can adapt to these rapidly changing conditions during the transition to a fully competitive market. While

regulation is always a second best alternative to competition, it nonetheless is critical to duplicate the incentives and benefits of a competitive market to the fullest extent possible. With a plethora of alternative investment opportunities available, LECs need the incentives that a competitive market would provide to make economically efficient investments in an advanced infrastructure. And with competitive pressures steadily increasing, LECs need the flexibility to compete on even terms and to introduce new and innovative services. Only then will they be able to deliver the full benefits of the information age to consumers.

The current price cap plan does not provide these same benefits. The current plan retains vestiges of rate of return regulation that present all the pitfalls of a cost plus system of government contracting. It blunts efficiency incentives and forestalls economically efficient investment. The current plan also incorporates intrusive and redundant regulatory controls that deny LECs the flexibility they need to compete and inhibit the introduction of innovative new services. Ironically, the most competitive services are subject to the most extensive constraints. As a result, it denies consumers the benefits that would result from a system that accurately duplicates the incentives of a competitive market.

The solution to these problems is four-fold. First, remaining elements of rate of return regulation must be eliminated. This means abolishing the sharing and lower-bound

adjustment mechanisms, and permitting LECs to adopt market driven depreciation practices. This will give LECs the incentives to make economically efficient investments, while placing the risk of these investments squarely on the shoulders of shareholders. It is the same approach the Commission has already adopted both for AT&T and for the cable TV companies.

Second, the productivity offset must be brought into line with the average productivity differential historically experienced by the industry. As demonstrated by a direct measure of LEC total factor productivity growth in the period since divestiture, the current offset is roughly double historical experience. The year-over-year price reductions required by this offset have forced LECs to aggressively cut costs in an effort to keep pace. During the initial period of price cap regulation, LECs did so by squeezing out inefficiencies during the transition from rate of return regulation. This resulted in the loss of thousands of jobs. But by the end of four full years of price cap regulation, these inefficiencies will have been wrung out. The same rate of cost reductions cannot be sustained in the future, and the artificially high productivity differential in the current plan cannot be achieved over the long term. On the contrary, LEC productivity growth will likely decline in the years ahead as competition intensifies and business is lost to other providers.

Third, the Commission should remove competitive, new and discretionary services from rate and price regulation. This

will give LECs the flexibility they need to compete, and create the same incentives that unregulated companies have to develop and introduce innovative new services that consumers want. To the extent tariffs for these services are required by the Communications Act, the requirements for LECs should be identical to those that apply to all other providers.

Fourth, greater flexibility is needed for any services that remain subject to price cap regulation. Of particular importance is greater pricing flexibility to respond to increasing competition, and the elimination of archaic regulatory obstacles to the introduction of new services such as the Part 69 waiver process and burdensome tariff filing requirements.

In addition, the Commission should eliminate the artificial incentive that currently exists for AT&T to use non-LEC access providers by mandating equal treatment of access charge reductions from LECs and all other providers.

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COMMENTS OF BELL ATLANTIC[1]

The existing price cap plan for local exchange carriers ("LECs") was a step in the right direction, and has been an improvement over traditional rate of return regulation for consumers and LECs alike. Nonetheless, improvements are needed to duplicate more fully the incentives and benefits of a competitive market, and to provide LECs the flexibility they need to compete in a rapidly changing environment. These improvements will promote economically efficient investment in the nation's infrastructure, deliver consumers the benefits of true competition, and establish regulatory parity between direct competitors.

Specifically, the Commission should a) eliminate the sharing and the lower-bound adjustment mechanisms in the current

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[1] The Bell Atlantic telephone companies include Bell Atlantic-Delaware, Inc., Bell Atlantic-Washington, D.C., Inc., Bell Atlantic-Maryland, Inc., Bell Atlantic-Pennsylvania, Inc., Bell Atlantic-New Jersey, Inc., Bell Atlantic-Virginia, Inc. and Bell Atlantic-West Virginia, Inc.

plan and permit LECs to adopt market based depreciation practices, b) adopt a corrected productivity offset more in line with past experience and future potential, c) remove competitive, new and discretionary services from price regulation, d) streamline the regulatory scheme for services still subject to price caps, and e) require AT&T to give equal treatment to access charge reductions from all providers.

I. Experience Shows That Price Caps Work, But Improvements Are Needed To Adapt To Changing Conditions

Experience under the limited plan now in effect proves that price caps work. Prices for interstate services have declined in both nominal and inflation adjusted terms,[2] and price cap LECs have pressed ahead with the deployment of new technologies that will provide the foundation for an advanced infrastructure.[3] The result has been more efficient and high

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[2] Price Cap Performance Review for Local Exchange Carriers, CC Dkt 94-1, NPRM, ¶ 25 (rel. Feb. 16, 1994). Bell Atlantic alone will have reduced prices by $1 billion in real, inflation adjusted terms as a result of the productivity offset and pricing below its cap during the first four years of price caps. See Bell Atlantic Annual Access Filings.

[3] NPRM at ¶ 29. In Bell Atlantic's case, for example, the number of miles of fiber deployed during the first three years of price caps (1.1 million) was twice the amount deployed during all prior periods combined (.5 million). (Source: ARMIS Data). Also, the lines equipped with digital switching increased from 48.3 to 70% by the end of 1993 (the first Bell Atlantic state to reach 100% was West Virginia with pure price caps at the state level), the availability of ISDN service increased from 36% to virtually 100% under Bell Atlantic's ISDN-Anywhere plan, and the lines equipped with SS7 increased from 85.3 to 97.5% by the end of 1993. (Source: ARMIS Data & 1993 Estimates).

quality telephone service,[4] the introduction of new or improved services based on these technologies,[5] and increased telephone penetration.[6] The broader effect on the U.S. economy as a whole has been increased economic efficiency and growth.

But while this experience shows that the existing plan was a step in the right direction, the telecommunications landscape is changing rapidly. Previously distinct industries and technologies are converging, and competition is intensifying.[7] Not surprisingly, this competition is strongest for the services that are most profitable, many of which are

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[4] NPRM at ¶ 27. For Bell Atlantic, service quality measured in terms of installation commitments met has remained at nearly 100% while installation intervals declined, and residential service quality complaints steadily decreased from 19.9 per million lines in early 1991 to 8.4 at the end of 1993. (Source: ARMIS Data).

[5] Of the 200 new service filings under price caps, see NPRM at ¶ 29, Bell Atlantic alone made 35.

[6] NPRM at ¶ 29. For the seven Bell Atlantic states, penetration increased from 93.6 in 1990 to 95% in the most recent quarter; the largest increase was in West Virginia under pure price caps. Compare Telephone Subscribership in the U.S. at 14 (rel. Feb. 1991) with id. at 13 (rel. Mar. 17, 1994).

[7] NPRM at ¶ 2 ("Within the last few years we have witnessed dramatic changes in telecommunications technology and markets...."); Stmt. of Reed E. Hundt before House Appr. Subcommittee at 8 (Apr. 18, 1994) ("We are witnessing an evolution of convergence of networks and markets....[a] range of companies, once segregated by product or service, will soon compete to provide voice, data, and video services."); Stmt. of Reed E. Hundt before Senate Appr. Subcommittee at 4 (Apr. 28, 1994) ("The telephone company of yeterday was thought to be a classic, natural monopoly.... Technology and enterprise have shattered this preconception. The telephone company of today faces competition as well as being a source of it.").

priced high to offset other rates that are kept artificially low for public policy reasons.[8]

Nowhere are these trends more apparent than in the case of interstate access services, where the Commission itself is actively fostering competition.[9] Competitive access providers ("CAPs") already serve virtually every major business center,[10] and are expanding into the local exchange.[11] Cable companies are moving aggressively into the access business, often in combination with local telephone companies such as Bell Canada,

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[8] See, e.g., Robert G. Harris, Economic Benefits of LEC Price Cap Reforms at 8-11 & App. B (May 9, 1994) ("Harris Study") (filed in support of USTA in this proceeding).

[9] NPRM at ¶ 22; see also Expanded Interconnection With Local Telephone Company Facilities, 7 FCC Rcd 7740, ¶ 1 (1992) (special access decision "will greatly increase the scope of interstate access competition, moving the telecommunications industry closer to a fully competitive environment"); Id., 8 FCC Rcd 7374, ¶ 1 (1993) (switched access decision will "bring the benefits of enhanced competition in the interstate access market to fruition by requiring expanded interconnection for switched transport services").

[10] Nationally, there are now 45 separately managed CAPs serving approximately 80 U.S. cities including all the top 25 metropolitan statistical areas. Huber, P., The Enduring Myth Of The Local Bottleneck (Mar. 14, 1994) ("Huber Study"). Likewise, in Bell Atlantic's seven state region, CAPs now operate in every state and in every major urban business center. Affidavit of Richard E. Beville at ¶ 5 ("Beville Aff.") (attached).

[11] Metropolitan Fiber Systems ("MFS"), for example, sought and was granted authority to provide local exchange service to businesses located throughout the state of Maryland. See Order No. 71155, Application of MFS Intelnet of Maryland, Inc. for Authority to Provide and Resell Local Exchange and Interexchange Telephone Service, Case No. 8584 (Md. PSC Apr. 25, 1994). MFS has similar applications pending in other states. Beville Aff. at ¶ 7a.

US West, or Southwestern Bell.[12] In fact, cable companies now control over 50 percent of competitive access revenues.[13] Long distance providers are doing likewise, both directly,[14] and through alliances with a host of wireless and wireline competitors ranging from McCaw and Nextel to British Telecom and Jones Intercable.[15] The result is that more than two-thirds of the demand for high capacity access in Bell Atlantic's region comes from areas that are already served by competing providers;[16] other services are or soon will be equally competitive.

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[12] Bell Canada purchased 30% of Jones Intercable, and plans to "expand into wireline local exchange communications and broader telecommunications services." "Jones Intercable, Inc. and BCE Telecom Int'l Announce Strategic Relationship," Press Release, Dec. 2, 1993 at 2. US West invested $2.5 billion in Time Warner, and the two plan to upgrade Time Warner's cable systems to bypass LECs. Fabrikant, "US West Will Buy Into Time Warner," New York Times at A1 (May 17, 1993). Southwestern Bell bought 100% of the cable systems serving two Washington, D.C. suburbs where it also provides cellular service.

[13] Huber Study at 22.

[14] MCI plans to enter 20 top U.S. markets, and to directly link local traffic to its long distance network. Keller, "MCI Proposes a $20 Billion Capital Project," Wall St. J., Jan. 5, 1994 at A3.

[15] AT&T has proposed to pay nearly $17.5 billion for McCaw, the nation's largest cellular carrier. See Huber Study at 32-33. MCI, which is now 20% owned by British Telecom, has announced a joint experiment to test local phone service in Alexandria, Virginia with Jones Intercable. Id. at 27. MCI also plans to pay $1.3 billion for a stake in Nextel, which is developing a nationwide digital wireless system, and has organized a consortium with cable companies and CAPs to build a nationwide wireless system. Id. at 33.

[16] Beville Aff. at ¶ 34; see also Huber Study at 21.

This environment demands a flexible regulatory structure that can adapt to these rapidly changing conditions during the transition to a fully competitive market. While regulation is always a second best alternative to competition, it nonetheless is critical that it duplicate the incentives and benefits of a competitive market to the fullest extent possible.[17] The current price cap plan no longer fills the bill.

II. The Current Plan Should Be Modified To Duplicate The Investment Incentives Of A Competitive Market

While LECs have deployed many new technologies in their networks, billions of dollars of additional investment will be needed to complete deployment of an advanced information infrastructure. With a plethora of alternative investment opportunities available and competitors making new inroads every day, LECs need the same incentives that a competitive market would provide to make economically efficient investments in the infrastructure.[18] This investment, in turn, will spur economic

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[17] Stmt. of Reed E. Hundt before Senate Appr. Subcommittee at 4 (Apr. 28, 1994) ("We exercise regulatory supervision... in order to replicate, as nearly as possible, the results that a competitive market would produce.").

[18] Harris Aff. at 15, 18, 25; see also Larry F. Darby, Price Cap Reform, Financial Incentives and Exchange Carrier Investment at 2-3, 15-23 (May 9, 1994) (submitted on behalf of USTA in this proceeding) ("Darby Study").

development and growth and produce significant benefits for the economy as a whole.[19]

The current price cap plan, however, retains vestiges of a rate of return regulatory scheme from a bygone era; it also includes a productivity offset that is roughly double the productivity growth that the industry historically experienced or could hope to achieve going forward. These aspects of the current plan blunt efficiency incentives and forestall economically efficient investment.

A. The Commission Should Replace The Sharing and Lower-Bound Adjustment Mechanisms With Pure Price Caps and Adopt Market-Based Depreciation Policies

The sharing and lower-bound adjustment mechanisms are holdovers from rate of return regulation; they were adopted solely as a safety net to protect against the possibility that the Commission might wildly miss the mark in its first attempt to structure a price cap plan for the LECs.[20] As a result, there no

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[19] E.g., Harris Study at 2 & Att. A. A macroeconomic study conducted by WEFA concludes that an improved price cap plan will produce a net increase of more than half a million jobs across all sectors of the economy over the next ten years, and an increase in GDP in 2004 of nearly $60 billion. The WEFA Group, The Economic Impact of Revising the Interstate Price Cap Formula at 1-2 (May 9, 1994) (submitted on behalf of USTA in this proceeding) ("WEFA Study").

[20] See Policy and Rules For Dominant Carriers, 5 FCC Rcd 6786, ¶ 120 (1990) ("LEC Price Cap Order").

longer is any reason to retain these parts of the plan.[21] On the contrary, there are strong reasons to remove them in favor of a pure price cap plan like the ones adopted for AT&T and for the cable companies.[22]

First, adopting a pure price cap plan will help to duplicate the incentives that a competitive marketplace would provide to undertake the risky investment needed to deploy an advanced infrastructure.[23] It will do so by providing LECs the same opportunity as in a competitive market to earn a return that

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[21] In fact, while individual LECs fell within both the sharing and lower bound adjustment ranges, the sharing is a function of regulatory policies that produce unrealistically long depreciation schedules. If LECs were permitted to use the same depreciation practices as AT&T or the cable industry, most LECs would not have shared but instead would have been in a position to take advantage of the lower bound adjustment to increase rates. For example, Bell Atlantic's 1992 earnings using AT&T's composite depreciation rates (Form M data) would have been only 9.3%, entitling it to a rate increase of over $60 million under the current plan. And using composite depreciation rates from publicly traded cable companies without significant non-cable holdings, see Paul Kagan Associates, Inc., The Cable TV Financial Databook (1993), Bell Atlantic's earnings would have been only 2.5%, entitling it to an increase of over $500 million.

[22] See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, ¶¶ 3, 5 (1989) ("AT&T Price Cap Order"); Implementation of Sections of The Cable Act of 1992 - Rate Regulation, 8 FCC Rcd 5631, ¶¶ 223-240 (1992).

[23] Harris Study at 19-23.

is in line with the risk involved.[24] The result will be to promote infrastructure investment to the ultimate benefit of consumers, and to produce economic development and growth.[25] And by eliminating the lower-bound adjustment, a pure price cap plan will place the risk of this investment squarely on the backs of shareholders.[26]

Second, adopting a pure price cap plan removes any conceivable reason for maintaining an archaic three year depreciation prescription process that artificially inflates LEC earnings, and unnecessarily burdens the Commission and LECs alike.[27] By producing artificially long depreciation schedules that are out of touch with the marketplace, this process also adds to the disincentive created by sharing to undertake new investment.[28] As a result, LECs should be allowed to propose

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[24] In contrast, a sharing mechanism acts as a brake on LECs' incentives to undertake this investment by arbitrarily limiting the return that can be earned in exchange for taking this risk. See Harris Study at 20. Sharing also limits the ability of LECs to raise the capital needed to fund these investments, since LECs must compete for capital with unregulated firms and other regulated firms such as cable and AT&T that are not limited so. Like rate of return regulation, sharing encourages LECs to invest where they do not face the same constraints, whether overseas or in unregulated areas.

[25] Harris Aff. at 20-21; WEFA Study at 1-2.

[26] Harris Study at 20-21.

[27] The Commission previously declined to permit LECs to propose their own depreciation rates, but recognized that a different result may be appropriate once sharing is eliminated. Simplification of the Depreciation Prescription Process, 8 FCC Rcd 8052, ¶ 43 (1993).

[28] Harris Study at 21-23.

market-based depreciation policies using their own best assessment of the economic lives of their assets. This is the same flexibility the Commission has given to cable and to AT&T.[29]

Third, adopting a pure price cap plan removes any possible concerns that LECs might subsidize competitive services by shifting costs onto services that are less competitive.[30] The current plan goes far toward eliminating the harmful incentives produced by rate of return regulation to engage in this type of behavior. But removing the sharing and lower-bound adjustment mechanisms will sever the last remaining link between artificial regulatory costs and rates, and will completely eliminate any possible incentive to do so.[31] As a result, it also eliminates the need for arbitrary and economically inefficient cost allocation schemes that burden regulators and LECs alike.

Fourth, adopting a pure price cap plan for LECs will promote competitive parity. Both AT&T and cable companies are subject to pure price caps, while other competitors such as MCI

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[29] Implementation of Sections of the Cable Act of 1992 - Rate Regulation, MM Dkt 93-215, Report and Order and FNPRM at ¶ 133 (rel. Mar. 30, 1994) (refusing to prescribe cable depreciation rates even for cost of service cases because it "would impose unjustified burdens without providing a balanced benefit"); Simplification of the Depreciation Prescription Process, 8 FCC Rcd 8052, ¶ 92 (allowing AT&T to propose its own depreciation rates subject only to review for reasonableness).

[30] Harris Study at 20-21.

[31] Id.

and CAPs are free of any price regulation. With the rapid convergence of previously separate industries, these companies will increasingly compete with one another -- both in the consumer market and in capital markets where they compete for investor dollars.[32] To the extent some of these competitors continue to be regulated, parity of regulatory treatment is critical to avoid artificially favoring or handicapping one over the other.[33]

Finally, LECs should be required to make a one time election at the start of a price cap plan that extends for a period of five or more years.[34] Making the plan optional will help to avoid the constitutional concerns a mandatory plan would raise,[35] and a properly structured multi-year plan will provide

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[32] Harris Study at 8-11; Darby Study at 2-3.

[33] Implementation of Sections of the 1992 Cable Act - Rate Regulation, MM Dkt 92-266, 2d Order on Recon., 4th Report and Order, and 5th NPRM at ¶ 24 (rel. Mar. 30, 1994) ("as the cable and telephone industries converge, it is important to treat them with as much regulatory parity as possible").

[34] NPRM at ¶ 99.

[35] A mandatory price cap plan with no lower bound adjustment would raise constitutional concerns to the extent it results in rates that do not provide a reasonable return. FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). The Commission has concluded that making such a plan optional addresses these concerns. See Implementation of Sections of the 1992 Cable Act - Rate Regulation, MM Dkt 92-266, 2d Order on Recon., 4th Report and Order, and 5th NPRM at ¶ 162, n.213.

LECs the regulatory certainty they need to make long term investment decisions.[36]

B. The Commission Should Reject Attempts To Reimpose Other Aspects Of Rate Of Return Regulation

The Commission also should reject attempts to reimpose other aspects of rate of return regulation.

In particular, including a one-time price adjustment or examination of LEC earnings as part of the current review is inappropriate.[37] Any action based on LEC costs or earnings would destroy the very incentives that price caps seek to create.[38] The message to LECs would be that unsuccessful efforts to innovate and become more efficient will be rewarded with higher rates, while successful efforts will be punished by regulatory attempts to recapture the benefits with reduced rates. In short, this effectively means a full scale return to rate of return regulation and all the harmful incentives it creates.

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[36] Harris Study at 30-31. Certainty in the regulatory environment is critical to LECs and their competitors alike if they are to accept the significant market risk involved in investing in an advanced infrastructures. Id. It also is critical to provide the stability they need to pursue educational and other public policy initiatives, for example by finding ways to ensure that schools and classrooms are connected to the advanced information infrastructure.

[37] See NPRM at ¶ 46.

[38] Harris Study at 30-31; NERA, Economic Performance of the LEC Price Cap Plan at 25-28 (submitted in support of USTA in this proceeding) ("NERA Study").

Likewise, adjusting prices for changes in interest rates would be a step backward toward cost of service regulation, and should be rejected out of hand.[39] Moreover, such an adjustment would serve no purpose. The inflation adjustment and productivity offset already serve to adjust for overall cost changes on an ongoing basis, including interest costs.[40] As a result, the effect of adding a separate ongoing adjustment factor for interest costs would be to double count these costs, and to skew the efficiency incentives from price caps.[41]

C. The Commission Should Adopt A Corrected Productivity Offset

The productivity offset of 3.3 percent included in the current plan substantially exceeds the productivity gains historically experienced by the industry.[42] The year-over-year

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[39] NERA Study at 25-28.

[40] Id.

[41] Id. In contrast to an ongoing adjustment, a one time adjustment would unfairly reward or penalize LEC's by locking in interest rates at a single point in time. Interest rates are cyclical, as the recent upturn in rates demonstrates. Vogel, "Investors Are Shrouded in Interest-Rate Gloom: Jobs Report Seen Prompting New Fed Action," The Wall Street Journal at C1 (May 9, 1994). Locking in current rates would unfairly penalize LECs as rates increase in the future.

[42] The current offset is composed of two parts: An estimate of historical LEC productivity growth of 2.8% and an added consumer dividend of .5%. The 2.8% historical estimate was based on a pair of studies, one long term and one short, that attempted to indirectly estimate LEC productivity based on incomplete data. LEC Price Cap Order at 67-98. Because the Commission concluded that neither of those particular studies was an adequate basis to set an offset, it selected a number at the midpoint of the range between the two estimates. Id.

price reductions required by this offset have forced LECs to aggressively cut costs in an effort to keep pace. During the initial period of price cap regulation, LECs did so by wringing out any inefficiencies left over from rate of return regulation. The result has been the loss of thousands of jobs.

This high rate of productivity growth cannot be achieved over the long term. After four full years under price caps, any historical inefficiencies will have been squeezed out of the business and work forces will have been pared back. As a result, the same rate of cost reductions cannot be sustained in the future. Under these circumstances, maintaining an overly aggressive productivity offset risks forcing LECs to cut costs below efficient levels, and will negate the investment incentives provided by price caps.[43] In contrast, adopting a more realistic offset will promote infrastructure development and a continued high quality of service.[44]

At a minimum, therefore, the Commission should adopt an offset more in line with the long term average of the total factor productivity growth historically experienced by the

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[43] Harris Aff. at 25.

[44] Id. The Commission has correctly held that a productivity offset "should not be changed either to recapture all profits, or to increase relatively low profits retroactively." See AT&T Price Cap Review Order, 8 FCC Rcd 6968, at ¶ 21. Here, in contrast, the offset was set incorrectly initially; a fact that should be corrected for by bringing it more into line with historical experience.

industry.[45] As Dr. Christensen demonstrates, the average post-divestiture differential between the total factor productivity growth of the LECs and the U.S. economy is 1.7 percent.[46] Even this number, however, likely overstates the potential for future LEC productivity gains and should be the absolute ceiling for any offset adopted here.

In fact, there are strong reasons to believe that future productivity growth will decline. First, increasing competition will act as a drag on productivity; this is true because the loss of business to competitors reduces output.[47] Second, the services that historically were most productive are now subject to the most competition. As these services are removed from regulation or lost to competition, the reduction in overall productivity for those services that remain subject to regulation will be magnified.[48]

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[45] As the Commission itself has previously recognized, "total factor productivity" is the "superior productivity measure," see AT&T Price Cap Order at 2979, and a long term average avoids the swings in productivity that occur over shorter periods, id. at 2990. Indeed, as Drs. Taylor and Christensen demonstrate, this is the only way to measure productivity for this purpose. NERA Study at 18; Lauritis R. Christensen, et al., Productivity of the Local Telephone Operating Companies (May 3, 1994) (submitted in support of USTA in this proceeding).

[46] Christensen Study at ii, 2. The Commission also has recognized that the measure on which to base an offset is the differential between the industry's rate of productivity growth and that of the U.S. economy as a whole. AT&T Price Cap Order at 1987, 1989.

[47] As Dr. Christensen shows, LECs experience economies of density, and a loss of business or customers will directly reduce productivity growth. Christensen Study at v, 14.

[48] Id.

This also means that going forward the Commission should eliminate the one-half of a percent consumer dividend that was tacked on to its own previous best estimate of LEC productivity. The dividend was intended to "challenge" LECs to improve their productivity by eliminating historical inefficiencies during the transition from rate of return regulation.[49] But LECs have now done so, and customers will continue to receive the benefit of the lower rates that resulted.[50] As a result, the dividend can no longer be justified, and is counterproductive to the extent it produces an offset inflated above the historical average.

Finally, a more reasonable offset will promote parity with the cable industry since the Commission recently proposed a comparable offset of 2 percent for cable.[51] In no event, however, could the Commission adopt an offset for LECs that is higher than the offset ultimately adopted for cable. Because

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[49] Policy and Rules Concerning Rates for Dominant Carriers, 3 FCC Rcd 3195, ¶ 386 (1988).

[50] During the first four years of price caps, the consumer dividend will produce total rate reductions of approximately $560 million nationwide. The total going forward annual impact of the consumer dividend embedded in rates will be $611 million. See Price Cap LECs' Annual Filings 1990-94.

[51] See Implementation of Sections of the 1992 Cable Act - Rate Regulation, MM Dkt 93-215, Report and Order and FNPRM at ¶ 314-315 (rel. Mar. 30, 1994).

cable has deployed fewer productivity-enhancing technologies (such as digital switching and fiber optics), its potential for future productivity gains is much greater than the LECs.[52] As a result, to the extent the offsets for these two industries differ, the offset for cable must be higher.

D. The Commission Should Eliminate The Separate Carrier Common Line Adjustment Formula

The current plan should be simplified by eliminating the separate common line adjustment formula, and treating the common line basket the same as any other.

When the current price cap plan was adopted, a separate common line adjustment formula was included because of concerns that LECs had only limited ability to influence the growth in common line demand.[53] The formula incorporated an additional productivity factor known as little "g" representing the growth in minutes of use per access line.[54] The intent was to return 50

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[52] Harris Study at 28. Likewise, AT&T also should be expected to experience higher productivity gains than the LECs. This is true in part because long-haul service is less labor intensive than a local delivery service like the exchange and exchange access business, and the deployment of new technologies will have a correspondingly greater impact on AT&T's overall productivity. It also is true because AT&T has large amounts of excess capacity and fewer non-traffic sensitive costs than the LECs, which creates the potential for higher rates of productivity growth.

[53] LEC Price Cap Order at ¶¶ 69, 73.

[54] Id.

percent of this growth to the carriers that pay the common line rate in the form of lower rates.[55]

Unlike the productivity estimates relied on when the current plan was adopted, however, the total factor productivity study conducted by Dr. Christensen already incorporates the effects of little "g."[56] Moreover, the common line formula does not work as intended, but actually returns substantially more than half the growth in common line demand to carriers in lower rates.[57] Under these circumstances, the additional complexity and burden created by the separate common line formula are unnecessary, and it should be eliminated.[58]

III. The Current Plan Should Be Improved To Provide LECs With Greater Flexibility To Compete In The Marketplace

As competitive pressures steadily increase, it is critical for LECs to have sufficient flexibility to compete on even terms with other providers and to introduce new and

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[55] LEC Price Cap Order ¶¶ 69, 73.

[56] Christensen Study at 3; NERA Study at iii.

[57] In Bell Atlantic's case alone, the cumulative reduction in rates in excess of the 50% that was intended to be returned will be over $70 million during the first four years of price caps. (Calculated based on data from Bell Atlantic Annual Filings).

[58] This means that all the rates in the common line basket would be set using an actual price index, except that subscriber line charges would continue to be capped at $3.50 and $6.00, respectively.

innovative services.[59] Only then will consumers receive the full benefits of the information age.

The current plan, however, incorporates intrusive and redundant regulatory controls that were typical of rate of return regulatory schemes of old. As a result, the current plan denies LECs the flexibility they need to compete and inhibits the introduction of innovative new services; it also denies consumers the benefits that would result. And by causing LECs to lose business even when they are the more efficient provider, it will jeopardize universal service objectives to an increasing degree as competition intensifies.

A. The Commission Should Remove Competitive Services From Regulation

Even in its best form, regulation is a second-best alternative to the disciplines of a competitive marketplace. In areas where competition exists, continued regulation is unnecessary and counterproductive.[60] The current plan, however, has matters precisely backwards. It subjects the most

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[59] See Stmt. of Reed E. Hundt before the Senate Commerce Committee at 14 ("as competition increases, the incumbent telephone companies will require pricing flexibility to respond to competitive offerings").

[60] NPRM ¶ 92 ("[R]egulatory constraints...become unnecessary or counterproductive when market forces generated by competition effectively assure reasonable...rates."), id. ("Rate regulation in these circumstances may impede the incumbent carrier's ability to compete vigorously rather than protecting consumers.").